Executive Summary

On January 26th USAID hosted Dr. Geoffrey Garrett from the University of California, Los Angeles and Dr. Branko Milanovic from the Carnegie Endowment for International Peace to discuss their work on the effects of globalization on income inequality, both within and between countries. This event was the first in a series "unpack" the concept of globalization to better understand how this phenomenon affects people in the developed and developing worlds and the implications of these effects for USAID’s programs.

In the course of their presentations, the speakers suggested the following:

- There is a lack of consensus among development professionals on the effects of globalization on income inequality within and between countries
- Reasons for this disagreement include differences in measures of openness and a lack of clear understanding as to the causal relationship between growth and increasing trade flows. Both Dr. Garrett and Dr. Milanovic believe:
  - In most cases trade has followed growth as opposed to the other way around
  - Overall trade policy is a better measure of a country’s trade openness than the ratio of Trade/GDP
- Globalization's effects differ depending on a country's income level and its degree of openness to goods and capital
  - Globalization tends to benefit high income countries, which have advantage in high skill industries, and low income countries, which have advantage in manufacturing industries
  - Middle income countries are unable to compete in high skill or manufacturing industries and are therefore hurt by globalization
- The expected convergence of income between rich and poor countries predicted by economic models and theories about globalization has not occurred
- Empirically income inequality both within and between countries has increased in the past fifty years
- In light of these facts and increased understanding about the effects of globalization, the Washington Consensus must be reassessed
  - Capital market liberalization should only be undertaken after key financial institutions are in place to mitigate the exchange rate volatility and risk accompanying the free movement of capital
  - Privatization and deregulation of former government industries without the rule of law and a functioning judiciary will result in sub-optimal outcomes
- The best policy approach for middle income countries is extensive investment in infrastructure and education to improve their competition in the knowledge industries
- Income inequality is detrimental to growth. International lending institutions and bilateral donors should emphasize reduction in inequality as opposed to reduction

in inflation, because reduction in inequality will have a more positive effect on growth

- The global middle class is much smaller than commonly believed. The world's population is largely composed of two groups, the majority who are poor and a small minority who are rich
- Globalization has produced asymmetric income results in which rich people have benefited much more than poor people. International institutions and bilateral donors need to address these effects constructively

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Dr. Garrett's Presentation

Dr. Garrett presented the findings of his recent paper "Globalization and Inequality: What Are the Facts?" Dr. Garrett, a political scientist, chose to examine a topic typically dominated by economists because of globalization's profound effects on the political systems of both developed and developing countries. There is currently a lack of consensus among development professionals on the effects of globalization on inequality and economic growth (termed "dueling globalizations" by Dr. Garrett). Therefore, he attempted in his research to examine the economic effects of globalization, so as to more fully understand how the "political fallout" will manifest itself

Central Question: What is the effect of globalization on income inequality, both within and between countries?

One side in the globalization debate, put forth by scholars such as David Dollar and Aart Kraay and presented in the World Bank's report "Globalization, Growth and Poverty," believes globalization has benefited the poor and led to a decrease in inequality

The other side, represented by Dani Rodrick and Branko Milanovic, disputes this contention and points to the increase in inequality both within and among countries observed in the past fifty years

There are several reasons for this difference of opinion:

- Differences in the methods used to measure openness. The World Bank uses trade/GDP as its indicator for a country's level of openness, while many scholars, Dr. Garrett included, contend that overall trade policy should be used as the measure of a country's openness.
- A lack of agreement about the causal relationship between growth and increases in trade flows. The World Bank contends that increases in trade flows fuel growth, while Dr. Garrett claims that the relationship is more complex and that in reality economic growth stimulates increases in trade flows

Findings
In his analysis, Dr. Garrett has found what he termed "three worlds of globalization," three groups of countries affected differently by globalization based upon their income level and degree of openness to trade and capital

1. The first world: Rich countries that have benefited greatly from globalization. Growth has increased due to their advantage in knowledge based economies. However, income inequality within these countries has risen as a result of a decrease in manufacturing jobs

2. The second world: Poor countries that have expanded their openness to trade have also benefited from globalization; their growth rates have increased and their internal income inequality has decreased. This finding holds true even in Sub-Saharan Africa. However, greater capital mobility has resulted in increased exchange rate volatility in poor countries

3. The third world: Middle income countries that have mostly suffered from globalization. They are unable to compete in the knowledge or manufacturing sectors, resulting in slower growth and greater national income inequality (than the first and seconds worlds of globalization)

Conclusions
Dr. Garrett suggested several conclusions based upon his findings:

Globalization is inevitable
- The prior period of globalization (1870-1914) was interrupted and ultimately reversed by the First World War
- However, the current globalization would be difficult to reverse. It is deeper in many ways than its predecessor and this greater degree of interconnectedness between countries makes it hard to imagine a reversal of globalization even in the face of another world war

The policy options to address globalization for low income countries are different than those for middle income countries

- Low income countries are best served by adopting policies that increase trade openness to take advantage of their comparative advantage in the manufacturing and agricultural sectors
- Middle income countries are best served by intensive investment in infrastructure and education to improve their competitiveness in knowledge industries. They must address corruption and rule of law issues before foreign direct investment or foreign aid can be effective.
- The formation of regional free trade areas between middle income countries is another possible policy solution. These areas need to be anchored by access to a large market with the potential to import a significant quantity of goods to be effective

The Washington Consensus needs to be reassessed

- Capital market liberalization should only be undertaken after appropriate financial institutions are in place to mitigate the exchange rate volatility and risk accompanying the free movement of capital
- Privatization and deregulation of former government industries without the rule of law and a functioning judiciary will result in sub-optimal outcomes

Dr. Milanovic's Presentation

Dr. Milanovic outlined his views of globalization's effects on income inequality, primarily focusing on inter-country inequality

Central Question: Do the observed effects of globalization correspond to the economic theories/models and to conventional wisdom about globalization's effects?

The mainstream view of globalization and classic economic theories/models hold that poor countries opening themselves to trade will experience economic growth, poverty reduction and a decrease in their domestic income inequality. This is the fairly simple view behind the Washington Consensus

Dr. Milanovic ascribes to another, more nuanced, view: That openness to foreign trade and capital can lead to an increase in income inequality, both within and between countries. Increases in intra-country inequality hurt economic growth and hinder poverty reduction. Additionally, Dr. Milanovic maintains that trade openness is not an easily controlled policy variable and that in most cases growth brings increased trade, not vice versa

Findings/Data

Classic economic theory predicts that increasing trade flows between poor and rich countries will lead to decreasing inter-country income inequality

Dr. Milanovic pointed out that reality has been very different than this prediction

- The expected convergence of income between poor and rich countries has not occurred, even when relatively low performing countries, such as those in Sub-Saharan Africa, are removed from the dataset
- The ratio of income per capita for the top five percent of people in the world to the bottom five percent is 100 to 1 in terms of purchasing power parity. This ratio has increased during the past thirty years
- The world is made up of mostly poor people and a few rich ones. There is only a very small middle class in the world
- Globalization tends to lead to one-to-one gains for both poor and rich people. Everyone gains in proportion to their initial income and therefore globalization exacerbates inequality
- Income gains from globalization increase poor people's utility only if they ignore their increasing relative poverty

Conclusions

Dr. Milanovic outlined some national policies that need adjustment to reshape the impact of globalization on poor countries:

- The single focus on inflation has been exaggerated; the effects of inflation below 20% are not detrimental to growth or inequality
- Inequality matters because of its negative effect on growth via education, health care, misallocation of labor, demand for higher tax rates and political instability (Nancy Birdsall presented these ideas in her paper "Why Inequality Matters")
- Privatization and deregulation are not always good; there is a need for institutions to mitigate the potential negative impacts of these actions
- Capital account openness increases volatility, as Dr. Garrett pointed out, especially when key financial institutions are not in place or functioning effectively
- User fees for health and education diminish access to these services and thus reduce GDP per capita and increase income inequality within countries
- The privatization of pensions is not as successful as was originally thought

In addition various global policies should be reconsidered:

- Poor country representation in international financial institutions such as the World Trade Organization, the World Bank and the International Monetary Fund must be increased
- Rich countries need to reform their immigration policies to allow greater labor mobility
- The problem of asymmetric globalization in which rich people have benefited much more than poor people must be addressed by international institutions and bilateral donors

Discussion

The discussion session focused on three topics:

Current Trade Policy

- Tariffs have been reduced to a much greater extent in the developing world than in the developed world. However, tariffs in developing countries started at much higher levels. Non-tariffs barriers to trade have been increasing recently
- Much of US security policy was based on economic openness, pre-September 11th. The movement away from openness in the past two years has been detrimental to both US's security and the world economy

Downsides of Globalization

- The populist political backlash occurring in Latin America is largely a result of the broken promises of globalization in which the anticipated economic growth did not materialize

Effects of Trade on Government

- Countries that trade more have bigger governments
- Countries with left-leaning governments have less income inequality than those with right-leaning governments. This is interesting because developing countries do not have much ability to collect income taxes so as to progressively redistribute income. Therefore, left-leaning developing countries must be affecting the structure of labor markets, probably through expanding government employment